BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ORANGE SAVINGS AND LOAN ASSOCIATION)

Appearances:

For Appellant: Joseph Mayer
Certified Public Accountant

For Respondent: Jack E. Gordon
Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the disallowance by the Franchise Tax Board of the claims of Orange Savings and Loan Association for refund of franchise tax in the amounts of $2,829.03 and $3,179.33 for the income years 1959 and 1960, respectively, and pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Orange Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $2,469.08, $8,591.23, $14,878.84, and $2,553.01 for the income years 1960, 1961, 1962, and 1964, respectively. Since the filing of this appeal, respondent has made a concession with respect to one adjustment and thereby agreed that the deficiency assessments for the income years 1960, 1961, 1962, and 1964 should be reduced to $2,299.99, $8,390.47, $14,534.47, and $2,419.01 respectively.

The question presented is whether respondent properly disallowed a percentage of appellant's additions to its reserve for bad debts for the years on appeal.

Appellant uses the reserve method of deducting bad debts. It calculated the ratio of losses to outstand-

ing loans by utilizing its own bad debt experience for the selected base years, 1928 through 1947. Pursuant to the option granted for determining bad debt losses in regulation 24348(a), subdivision (5), title 18, California Administrative Code, appellant determined the amount of losses on sales of foreclosed real estate during the base period by taking losses into account at the time of the subsequent sale. In accordance with this method, the amount by which the basis of the property exceeds. the sale price is the amount of loss recognizable. In determining the basis of the property, capitalizable items are included as part of the basis.

In determining its bad debt ratio, appellant capitalized and thereby added to the basis of the property sold, certain expenditures totaling $8,072.50. However, these were described as "repairs" on its schedules and have been deducted as ordinary and necessary business expenses. Respondent disallowed capitalization on the ground that appellant had not established that any of these payments represented expenditures that should have been capitalized rather than deducted as current maintenance expenses.

Appellant also capitalized "taxes and liens" in the amount of $2,760.21, allegedly representing taxes which should properly have been added to the basis of foreclosed property sold, These payments also had been deducted as ordinary and necessary business expenses. In view of the absence of accurate records, appellant was unable to trace specific taxes to individual properties, lien dates, and tax periods, Respondent disallowed capitalization since it could not determine what amount, if any, should be added to basis rather than deducted. Appellant also capitalized "legal expenses" totaling $4,601.97, which were disallowed,

Appellant also, claimed that certain "earthquake losses" totaling $9,992.59 should properly be included in oomputing the bad debt ratio. This amount was excluded by respondent on the ground that losses attributable to earthquake damage were not proper components of a taxpayer ' s loan loss experience,

In determining the bad debt ratio, respondent increased the amount of depreciation which appellant had used in computing the basis of the real estate which it owned. Specifically, respondent increased the depreciation by $29,891.65, thereby reducing the basis of such property. For the years after 1935 respondent used the amount of depreciation actually deducted on appellant's

state tax returns. For the years prior to 1936 when there were no such returns, respondent used a useful life of twenty years, the approximate average of the useful lives shown on the returns for the years following 1935.

Respondent's various disallowances decreased the losses during the base period, thereby reducing the allowable bad debt deductions for additions to the income. for the years on appeal.

Appellant contends that the various expenditures and losses were experienced as a consequence of the repossessions arising from loans and therefore should be considered in computing bad debt losses.

Section 24348 of the Revenue and Taxation Code, provides in part:

> (a) There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts....

The Legislature, by its enactment of section 24348, has made the reasonableness of an addition to a reserve for bad debts a matter within the discretion of respondent. The reserve method is designed to provide a more convenient means of arriving at net income than allowing bad debts only as sustained. This convenience is primarily for the benefit of the taxpayer who may instead, if he wishes,, deduct bad debts as they become worthless. (Appeal of American Savings and Loan Ass'n of California, Cal. St. Bd. of Equal., Nov. 19, 1968; Appeal of People's Federal Savings & Loan Ass'n, Cal. St. Bd. of Equal., June 24, 1957.) Respondent 's disallowance of the deductions claimed by appellant must therefore be upheld unless appellant can sustain the heavy burden of proving that respondent has acted arbitrarily and capriciously, thereby abusing its discretion. (First National Bank in Olney 44 T.C. 764, aff'd 368 F.2d 164; Appeal of Silver Gate Building and Loan Ass'n, Cal. St. Bd. of Equal., Aug. 19, 1957.) It is noted that even though no actual bad debt losses were sustained by appellant for the period from 1959 through 1964, the addition to the reserve allowed by respondent for that period was in excess of $950,000.

Appellant has produced no evidence as to the nature of its expenditures for "repairs." The burden of proving whether a payment constitutes a currently deductible expense or a capital expenditure is clearly imposed upon the taxpayer. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348]; Philip Dietz, 7 B.T.A. 1048.) Lack of adequate records, even without fault, does not shift the burden, (Kirkland v. United States, 267 F. Supp. 259.) A currently deductible repair is an expenditure to keep property in an ordinarily efficient operating condition, not adding to the value of property nor appreciably prolonging its life. It keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. It is distinguishable from expenditures for replacements,, alterations , improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use, One is a deductible maintenance charge , while the others are additions to capital investment not to be applied against current earnings . (Illinois Merchants Trust Co., 4 B.T.A. 103; Kirkland v. United States, supra.) Moreover, appellant's treatment of the transactions on its records as currently deductible expenses is indicative of the true character of the transactions . Accordingly, respondent properly treated these expenses as maintenance expenses deductible against current earnings . Inasmuch as they were not shown to be proper additions to the basis of the property, the fact that these expenditures were not recovered upon ultimate sale does not establish any loss because of any decrease in value of the property reflected by a reduced sales price.

With respect to the claimed capitalizable expenditures for "taxes and liens ," no showing has been made of specific payments for particular property which should be added to the basis . There was no evidence that such items should have been treated as anything other than payments deductible against current earnings. Again, appellant's treatment of the transactions on its records as currently deductible expenses is indicative of their true character . Appellant has not introduced evidence establishing that the "legal expenses" were paid in connection with the acquisition or disposition of the properties to which they were related, nor in connection with questions concerning the title to such properties. Accordingly, appellant has not shown that these should either be added to the cost of such properties or deducted from their selling price in determining gain or loss on their ultimate disposition, They could just as easily

have been ordinary and necessary deductible business expenses incurred with respect to matters unrelated to title questions, not to be considered in determining the loss on the sale of such properties.

With respect to earthquake losses, it is well established that the bad debt reserve is not intended to provide an accumulation of surplus funds against future contingencies. (S.W. Coe & Co. v. Dallman, 216 F.2d 566; Appeal of People's Federal Savings and Loan Ass'n, supra.) Losses due to natural calamities do not appear to be in the nature of bad debts. Furthermore, actual earthquake losses in no way reflect any reduction in sales price of the property occasioned by depressed market conditions. Appellant asserts that a portion of the amount disallowed did represent a loss relating to market conditions rather than earthquake loss. However, there has been no substantiation of this assertion.

With respect to depreciation, the best estimate of the useful life of a piece of property is usually the estimate made by the owner of that property at the time the property was in existence, in light of current prevailing conditions. Appellant's own estimates for all years after 1935 were examined by respondent and were not modified. Appellant received the benefit of the depreciation claimed for those post-1935 years. With respect to the period before 1936 it would seem reasonable that the useful lives of appellant's properties would be similar to the lives examined in subsequent years and approved by respondent without modification. Appellant places reliance upon Bulletin F of the Internal Revenue Service (Bulletin F, "Estimated Useful Lives and Depreciation Rates"), which supplies guidelines of useful lives for various types of depreciable property and provides for a 33-1/3 year life guideline for inexpensive dwellings. The same bulletin, however, indicates that a taxpayer's operating policy must also be considered in determining what the useful lives should be for that particular taxpayer. We conclude that respondent has not abused its discretion. Furthermore, appellant's other assertions that in certain instances depreciation was taken upon the wrong properties has not been substantiated.

We must, accordingly , conclude that respondent properly disallowed a percentage of appellant's addition to the reserve for bad debts for the years under appeal.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Orange Savings and Loan Association for refund of franchise tax in the amounts of $2,829.03 and $3,179.33 for the income years 1959 and 1960, respectively, be and the same is hereby sustained, and pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Orange Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $2,469.08, $8,591.23, $14,878.84, and $2,553.01 for the income years 1960, 1961, 1962, and 1964, respectively, be modified in accordance with respondent's concession. In all other respects the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 16th day of February, 1971, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary